Testimony

United States Senate Committee on the Judiciary

The Looming Foreclosure Crisis: How To Help Families Save Their Homes

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Jacqueline P. Cox

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Testimony of the Honorable Jacqueline P. Cox
Bankruptcy Judge for the United States Bankruptcy Court
for the Northern District of Illinois

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"The Looming Foreclosure Crisis: How To Help Families Save Their Homes"
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Senator Durbin, members of the Committee, I genuinely appreciate the opportunity to address the Senate on protecting home ownership and helping families deal with burdensome home mortgages. I speak for myself; I do not represent the Judicial Conference of the United States or the Administrative Office of the Courts.

Because home ownership represents economic inclusion and because of the disparate impact of the mortgage crisis on African Americans and Latinos, passage of the Durbin bill is critical. The Bankruptcy Code generally allows reorganizing debtors in Chapters 11, 12 and 13 to bifurcate secured debt. Plans strip down claims to the value of the collateral, the secured portion, which the debtor would pay in full; the balance, the amount of the claim that exceeds that value, gets treated as an unsecured claim. In the Chapter 13 context the unsecured amount would be paid under the plan by a percentage based on the debtor's income. The best efforts provision of §1325 (a)(4), a plan confirmation requirement, requires that the value of property to be distributed under the plan on account of each unsecured claim be not less than the amount that would be paid on such claim if the estate were liquidated under Chapter 7.

Section 1 of the Helping Families Save Their Homes in Bankruptcy Act of 2007 will allow a debtor to modify mortgage debt if the debtor's income is insufficient to pay the mortgage. The income limitation is important; it limits this extraordinary relief to those homeowners who need it. Homeowners who can afford their payments will not receive a windfall.

Allowing the strip down of mortgage debt to the collateral's fair market value reflects the economic realities of the lenders' situation. The lender who forecloses on a loan will recover the value of the home and receive a deficiency claim when the debt exceeds the value of the home. Non-recourse states limit recovery to the value of the home.

When Americans purchase homes the most important consideration is affordability. Most of us anticipate modest future increases in income, but can not afford mortgage interest debt that increases up to 40%. The Durbin bill interest rate section allows the debtor to pay the stripped down amount at an interest rate equal to the rate published by the Board of Governors of the Federal Reserve System regarding the annual yield on conventional mortgages, with a reasonable

premium for risk. Under the U.S. Supreme Court decision in Till v. SCS Credit Corp., Chapter 13 debtors now follow a similar standard when adjusting interest rates on non-residence secured debt.
"Taking its cue from ordinary lending practices, the approach begins by looking to the national prime rate, reported daily in the press, which reflects the financial market's estimate of the amount a commercial bank should charge a creditworthy commercial borrower to compensate for the opportunity costs of the loan, the risk inflation, and the relatively slight risk of default. Because bankruptcy debtors typically pose a greater risk of nonpayment than solvent commercial borrowers, the approach then requires a bankruptcy court to adjust the prime rate accordingly."

I quote the Supreme Court to emphasize that interest rates are adjusted in our proceedings routinely. In fact, since the 2004 Till decision I have held only 2 or 3 hearings involving disputes over interest rate adjustments. The bar and the financial services community have very little trouble in this regard.

The Durbin bill also waives the pre-petition credit counseling requirement which was added to the Bankruptcy Code in 2005 under the Bankruptcy Abuse Prevention and Consumer Protection Act. Because most debtors facing foreclosure, probably because of fear or denial, wait until the week of a foreclosure sale to seek bankruptcy relief, credit counseling offers them no help. The briefing that debtors are required to receive outlines the opportunities for available credit counseling and assists such individuals in performing a related budget analysis. Once a foreclosure action has been filed, the homeowner needs more than a briefing or help in analyzing a budget.

I am particularly supportive of the bill's §201 which combats excessive fees. It allows fees, costs and other charges to be added to the secured debt only if notice of such additional charges is filed with the court within a year of when they are incurred or 60 days before the conclusion of the case. Failure to give notice will be deemed a waiver of such fees and any attempt to collect them shall constitute a violation of the discharge injunction and the automatic stay.

This policy reflects the practice of the United States Bankruptcy Court of the Northern District of Illinois. Our Model Plan for Chapter 13 cases requires the case trustee at the end of the plan to notify all parties that the mortgage cure amount has been paid, satisfying all pre-petition obligations, requiring the lender to treat the mortgage as reinstated. The lender can dispute this and have the court resolve the dispute.

The bill allows a plan to waive prepayment penalties. This assists debtors who can arrange to refinance their obligations under more favorable terms. Such penalties do not compensate lenders for costs, they only serve to punish debtors.

I agree with the position of the National Bankruptcy Conference's remarks before the House of Representatives on October 30, 2007 regarding similar legislation. On behalf of the NBC Attorney Richard Levin compared the plight of homeowners with that of family farmers in the 1980s. There is clear precedent for Congress to solve the mortgage crisis by allowing debtors to bifurcate or strip down mortgage debt. In the 1980's farm values dropped dramatically and lenders could not renegotiate farm debt to reflect falling land prices. The good work of Senator

Charles Grassley and Representative Mike Synar created Chapter 12 of the Bankruptcy Code which provided a platform for the rational court-supervised modification of farm loans. It has been a success and is now a permanent part of the Bankruptcy Code. As lenders and borrowers came to understand its operation, they were often able to modify mortgage obligations on their own, without the bankruptcy court's involvement. The Bankruptcy Code provisions provided a model for non-bankruptcy workouts in the family farmer context. Similarly, the Helping Families Save Their Homes in Bankruptcy Act of 2007 can become a model for out of court modifications.

The Chapter 12 experience provides guidance for amending Chapter 13 to address the current mortgage crisis. Chapter 12 of the Bankruptcy Code permits family farmers to modify mortgage debt on their farm land, to reamortize the debt over a period of years, and to save the family farm. Chapter 12 overcame the inability of farm lenders to negotiate terms that reflected the economic realities of family farmers in the 1980's. Many home mortgage lenders today face the same inability to deal with the economic reality regarding today's rapidly falling housing market, the decrease in home values making it difficult to secure loans because the outstanding loans exceed the value of the homes. Now, Chapter 12-style adjustments to Chapter 13 can provide the same sort of relief to homeowners trapped in impossible mortgages.

When Congress limited modification in Chapter 13 of a mortgage on the debtor's principal residence in 1978, no similar limitations were imposed on mortgages on vacation or second homes, on investment, rental, or business property, or on any other form of collateral. Whatever justification there might have been in 1978 for granting special protection to mortgages on a debtor's principal residence has evaporated as the marketplace has produced a baffling array of loans based more on a lender's ability to sell than on a borrower's ability to repay. Current financial conditions justify this legislation's important and needed change.

While allowing debtors to restructure their mortgages without current limitations will provide needed relief, some debtors can be expected to face unemployment and health issues after confirmation that limit their ability to meet their restructured obligations. With that in mind, I suggest that the Congress also address the situation of debtors who seek to refinance by incurring adjustable rate mortgages.

In Chapter 13 matters when debtors refinance their homes under §§ 364 and 1329 of the Code, the court has an opportunity to review and to rule on those prospective refinancing arrangements. Because of reports that borrowers have been promised fixed rate loans, but actually execute adjustable rate mortgages at closing, and because of concerns that borrowers often take on debt that they can not handle, I believe that adjustable rate financial products should be allowed only where it is shown that the debtor will be able to handle the obligation at a higher reset rate in the future.

Congress should also pass legislation requiring that adjustable rate mortgages be authorized for refinancing debtors in Chapter 13 cases only after the court finds that the debtor will have sufficient additional income in the future to pay for an increase in the loan's interest rate. This is consistent with the recent statement/rule of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency and the Office of Thrift Supervision that financial institutions should make loans only to borrowers who qualify to meet loan terms even after a loan rate resets higher. Bankruptcy courts are in a unique position to enforce this policy.

The following language could be added to 11 U.S.C. §§ 364 and 1329:

11 U.S.C. §364 (g):

(1) A debtor in a case under Chapter 13 of this title may incur debt secured by a lien on the debtor's residence only if authorized by the court, after notice and a hearing. Such authorization shall be granted only upon a finding by the court that the indebtedness is reasonable and will not impose an undue burden on the debtor.

(2)When the debtor seeks to incur credit by refinancing the debtor's residence, whether it is property of the estate or property of the debtor, the court must make a finding after a hearing, that the debtor will have sufficient income in the future to meet any applicable upward reset in the interest rate and other variable loan terms.

11 U.S.C. §1329 (d):

Any modification of a plan that includes incurring debt secured by a lien on the debtor's real property may be confirmed and authorized only in compliance with §364 (g) of the title.

I note that Representative Barney Frank may sponsor a bill that requires that a refinanced loan can not be offered if it "lacks a net tangible benefit" to the consumer. I already evaluate refinancing loans for debtors on this basis.

In conclusion, I support passage of Senator Durbin's Helping Families Save Their Homes in Bankruptcy Act. I believe this bill provides sensible and much-needed modifications to the Bankruptcy Code.